BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of: Petition for Forbearance from the Current Pricing Rules for the Unbundled Network Element Platform.	WC 03-157

RESPONSE OF THE CALIFORNIA PUBLIC UTILITIES COMMISSION TO VERIZON'S PETITION FOR EXPEDITED FORBEARANCE

The California Public Utilities Commission ("CPUC") hereby submits its Response to Verizon's Petition for Expedited Forbearance from the Current Pricing Rules for the Unbundled Network Element Platform and from the Federal Communications Commission's (FCC) Decision Permitting UNE-P carriers to collect per-minute access charges from long-distance carriers when it is the incumbent that actually provides the exchange access service.

BACKGROUND

Until the middle of the 1990's, local phone service was thought to be a natural monopoly. However, changes in governmental policies, as well as technological advances, have made competition among multiple providers of local service feasible. *AT&T v. Iowa Utils. Bd*. (Iowa Utils. Bd. I), 525 U.S. 366, 371

(1999). Specifically, Congress enacted the Telecommunications Act of 1996 ("1996 Act '), Pub. L. No. 104-104, 110 Stat. 56, to open local telecommunications markets to full competition. Congress recognized that no prospective entrant could entirely replicate an incumbent's existing local network infrastructure. Accordingly, in the local competition provisions of the 1996 Act, 47 U.S.C. 251-253, Congress provided the means for potential competitors to enter local markets by using the incumbents' networks in a variety of ways. In this regard, see 47 U.S.C. 251(c)(2)-(4).

Central to these local competition provisions is Section 251(c)(3), which entitles a new entrant to gain "access" to (i.e., to lease) an incumbent's "network elements," such as loops, switching capability, and other components and capabilities of the incumbent's network. 47 U.S.C. 251(c)(3); see also 47 U.S.C. 153(29) (defining "network element"). That provision permits new entrants, some of which may also have network elements of their own, to lease from an incumbent those elements that they need to provide services to their own customers. The 1996 Act further permits new entrants to "interconnect" their own facilities with those in the incumbent's network "at any technically feasible point." See 47 U.S.C. 251(c)(2).

However, the CPUC notes that throughout most of the United States, local telephone service in each community has long been dominated by a single incumbent "local exchange carrier," or LEC. That incumbent LEC, whether a Regional Bell Operating Company ("RBOC") or an independent carrier, owns almost all of the loops (the wires that connect telephones to switches) in its service area, along with the switches (which direct calls to their destinations) and the transport trunks (which carry calls between switches). The incumbents' control over those facilities in the past has solidified their de facto monopoly position in most local telecommunications markets. Indeed, even today, after years of efforts to open those markets to competition, incumbents still provide service to approximately 87% of local telephone lines and control of 96% of the network. See, FCC Public Notice, entitled "Federal Communications Commission Releases Study on Telephone Trends," dated August 7, 2003.

An incumbent may charge a new entrant for interconnection and access to network elements. If the incumbent and the new entrant cannot agree on those charges, the 1996 Act authorizes the state public utility commission, acting as arbitrator, to set the rates that the incumbent may charge. The state commissions must set rates that are "nondiscriminatory" and "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element." 47 U.S.C. 252(d)(1). These rates "may include a reasonable profit" for the incumbent. *Id*. In setting such rates, the state commissions must follow the FCC's pricing rules that give content to that statutory standard. See *Iowa Utils. Bd. I*, 525 U.S. at 383-385. Section 252(d)(1) provides as follows:

> Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section

> 251 of this title, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section-- (A) shall be--(i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and(ii) nondiscriminatory, and (B) may include a reasonable profit.

The 1996 Act also conferred significant benefits on incumbent LECs. For example, the 1996 Act "relieves the [RBOCs] of several of the burdens imposed by the [1982 AT&T Consent Decree], particularly by prescribing in [47 U.S.C.] § 271 a method whereby [they] can achieve a long-sought-after presence in the long distance market." *BellSouth Corp. v. FCC*, 162 F.3d 678, 690 (D.C. Cir. 1998) (emphasis and citation omitted); see also 1996 Act, Title VI, § 601(a)(2), 110 Stat. 143 (superseding GTE consent decree). It should noted that the RBOCs can only gain access to the long distance market if they meet a 14 point checklist which includes the requirements outlined above regarding the pricing of unbundled network elements. See 47 U.S.C. 271. The 1996 Act further entitles incumbent LECs, like other telecommunications carriers, to invoke its local competition provisions to expand their operations into new geographic areas and compete for the customers of other incumbents.

In August 1996, the FCC issued its initial order addressing the most basic issues involving local competition arising under the 1996 Act. See *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order ("Local Competition Order"), 11 F.C.C.R. 15,499

(1996). A cornerstone of that order is the FCC's choice of the cost methodology – "total element long-run incremental cost," or TELRIC – that state public utility commissions are to employ in resolving disputes between carriers about the "cost[s]" that Section 252(d)(1) allows the incumbent to recover from the new entrant for providing interconnection and network elements. See Local Competition Order, paragraphs 674-703.

TELRIC embodies a "forward-looking" approach to calculating the cost of providing network elements and interconnection. The essential objective of any forward-looking methodology is to determine what it would cost in today's market to replace the functions of an asset that make it useful. That is the asset's "forward-looking" cost (also known as its "replacement" or "economic" cost), as distinguished from the cost of duplicating the asset in every physical particular. Thus, if a loop cost $100 to install in 1985 but would cost $150 to install today (because, for example, labor costs have increased), the rate for leasing that loop would be based on the higher current cost figure.

In asking what it would cost to replace the functions that make an asset valuable, a forward-looking cost methodology requires an inquiry into currently available substitutes, including assets that perform the same functions as the asset in the incumbent's network, but that do not resemble the asset in all respects (*e.g.*, because they embody more efficient technology than the original asset). Some incumbents urged the FCC to foreclose any consideration of currently available substitutes in TELRIC. The FCC rejected the incumbents' suggestion as arbitrarily limiting the inquiry into the forward-looking cost of replacing an asset's useful functions in today's market. See, Local Competition Order at paragraphs 683-685.

The forward-looking purchase price of an asset is only one variable in the TELRIC compensation calculus. TELRIC also takes into account: (1) the duration of an element's useful life, as reflected in an appropriate economic depreciation schedule; (2) the cost of capital (*i.e.*, the required return, or profit, on investment); and (3) various types of expenses, such as maintenance expenses. See Local Competition Order at paragraph 703. One of TELRIC's principal objectives is to ensure an incumbent's opportunity, when leasing network elements to others, to recover the full forward-looking cost of those elements (including the cost of capital) over their useful lives.

Many of the essential details of implementing TELRIC are left to state public utility commissions. For example, the FCC did not set depreciation schedules itself; rather, state commissions determine, among other things, how best to adopt "specific depreciation rate adjustments that reflect expected asset values over time," including, where relevant, "expected declines in the value of capital goods." See, Local Competition Order at paragraph 686. Similarly, the state commissions have wide discretion to determine the appropriate cost of capital (or return on investment); they are authorized to increase the cost of capital, if warranted, to compensate incumbents for the risk of increased competition. See, Local Competition Order at paragraph 702.

The FCC rejected the argument of several incumbent LECs that the 1996 Act entitles them to rates for interconnection and network elements that are based on the "historical" (or "embedded") costs reflected on their accounting books. The FCC recognized that those costs could be either higher or lower than forward-looking costs. See, Local Competition Order at paragraph 705. The FCC reasoned that the use of historical costs would be economically arbitrary and would frustrate the competitive objectives of the 1996 Act. See, Local Competition Order at paragraphs 704-711.

In 1996 and 1997, the Eighth Circuit stayed and then invalidated the FCC's pricing rules on the ground that the 1996 Act gives state public utility commissions, not the FCC, general jurisdiction to interpret the pricing provisions of Sections 251 and 252. *Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 794-800 (1997). The Eighth Circuit's jurisdictional orders remained in effect until early 1999. During that period, the great majority of state commissions, including California, voluntarily applied the FCC's basic forward-looking methodology in adjudicating disputes between incumbents and new entrants over the rates to be charged for interconnection and network elements. In January 1999, United States Supreme Court reversed the Eighth Circuit's jurisdictional ruling, holding that the FCC has statutory authority to establish national pricing standards under Sections 251 and 252 of the 1996 Act. *Iowa Utils. Bd. I*, 525 U.S. at 376-385.

The Supreme Court remanded the case to the Eighth Circuit to address (among other things) the substantive validity of the FCC's cost methodology. In

July 2000, the Eighth Circuit issued its decision on remand. *Iowa Utilities Board v. FCC,* 219 F.3d 744 (8th Cir. 2000). In this decision, the Eighth Circuit upheld the FCC's authority to prescribe a pricing methodology based on forward-looking costs. Specifically, the court rejected the incumbents' argument that, in providing that the rates that they may charge new entrants for interconnection and network elements are to be based on "cost," Congress dictated a methodology based on historical cost. The court concluded that "the term 'cost,' as it is used in the statute, is ambiguous, and Congress has not spoken directly on the meaning of the word in this context."

The court therefore recognized that the FCC has the authority to make reasonable rules to resolve any such ambiguity (citing *Chevron U.S.A. Inc. v. NRDC, Inc*., 467 U.S. 837, 842-843 (1984)). The court then concluded that the FCC's adoption of a methodology based on forward-looking costs was reasonable. The court noted that "forward-looking costs have been recognized as promoting a competitive environment which is one of the stated purposes of the [1996] Act." *Ibid*. The court found that the FCC had adequately explained its conclusion that a methodology based on forward-looking costs "would best ensure efficient investment decisions and competitive entry," and thus "implement the new competitive goals of the Act." *Ibid*.

The Eighth Circuit did, however, invalidate the FCC's rule specifying that, apart from the "wire center" exception, the forward-looking cost of an element should be "based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration." The court held that this regulation was contrary to "the plain meaning" of Section 252(d)(1) and thus does not satisfy step one of a *Chevron* analysis.

The Eighth Circuit also rejected, as premature, the incumbents' assertion that the FCC's methodology, including its consideration of forward-looking costs, raises a serious Fifth Amendment takings issue that the 1996 Act should be construed to avoid.

On May 13, 2002, the U.S. Supreme Court issued an opinion in *Verizon Communications, Inc., et al., v. FCC*, 535 U.S. 467 (2002), which puts to rest any credible challenge in the future regarding the cost methodology that the California along with the FCC have used to set unbundled network element costs, *i.e*., the TELRIC methodology. Incumbent LECs had argued that TELRIC must include historic costs and investment. The Court soundly rejected this argument. The Court ruled that the FCC’s interpretation of cost is reasonable, and said that "[w]ithout any better indication of meaning than the unadorned term, the word ‘cost’ in section 252 (d) (1) gives the ratesetting commissions broad methodological leeway but says little about method to be employed." Given the enormous latitude given by Congress around the term “cost,” and given that Congress was clearly looking for the FCC to use a non-traditional method to establish costs for unbundled network elements, the use of TELRIC was found lawful. Moreover, in its decision, the Supreme Court rejected the arguments of the incumbent LECs regarding their “takings" claim, namely, that the TELRIC method violated the Fifth Amendment to the U.S. Constitution. There can accordingly no longer be any doubt that the TELRIC methodology has passes Constitutional muster.

Another FCC proceeding that will be most impacted by the Supreme Court's decision in *Verizon Communications* is the Triennial Review, which seeks to determine which unbundled network elements are still necessary and which elements' lack of availability will impair competitors' ability to compete. The recent Supreme Court decision will affect the FCC's Triennial Review decision for several reasons. This decision found that Congress intended to promote competition by allowing new entrants access to unbundled network elements, and that these entrants might not be able to enter the market without the ability to use unbundled network elements. The Supreme Court also appears to reject the idea that the availability of unbundled network elements is detrimental to facilities-based competition and should be limited for that reason. Given the Supreme Court's decision supporting the notion that competition should be encouraged by allowing new entrants into the marketplace, it will be more difficult for the FCC's Triennial Review decision to limit the number of unbundled network elements to be made available to potential competitors.

I. Competition is slowly gaining ground

Given the FCC's own analysis of the state of competition (see FCC Public Notice entitled "Federal Communications Commission Releases Study on Telephone Trends," dated August 7, 2003), it would appear that this is an <u>inauspicious</u> time to change the most basic stepping stone relating to competition, *i.e.*, the pricing of UNEs. While Verizon's Petition focuses on UNE-Ps, UNE-Ps are in fact nothing more than a subset of UNEs in general. The fact that the RBOCs are now beginning to face real competition as competitive LECs are slowly entering the marketplace should be seen by the FCC as an clear and strong indicator that its pro-competitive policies are finally bearing fruit. To change them now would be a step backwards and a rejection of the FCC's and Congress' longstanding bi-partisan commitment to the development of a truly competitive marketplace for telecommunications services.

Moreover, such a reversal of policy would have the inevitable effect of seriously dampening the emerging competitive markets and would roll back the past seven years of progress in implementing Congress' clear intention in the 1996 Act to open telecommunications markets to competition.

II. The Forbearance Petition is Illegal

If the FCC were to grant Verizon's Petition, it would be acting in an arbitrary and capricious manner. This is so because it would be practically impossible for the FCC to develop the evidentiary record upon which to base such an important and complex decision as designating the costing methodology for certain UNEs (which is the key to the continuing success of our movement towards competition in telecommunications markets) in the short period of time allowed for the FCC's action on a forbearance petition.

After a forbearance petition is filed, the FCC has one year to act on it or the petition is deemed granted. This one year deadline can be extended by the FCC for up to 90 days. See Section 401 of the 1996 Act. Clearly, this section was meant to deal with issues of less import than have been raised by Verizon in its forbearance petition.

Section 10 (d) of the Act limits the Commission's ability to forbear "from applying the requirements of § 251(c) or § 271 … until a determination that these requirements have been fully implemented." 47 USC §160 (d). At this time, these two sections referred to in Section 10(d) of the 1996 Act have not been fully implemented. The most obvious example is Section 251(c), pertaining to the definition of and prices for UNEs. The implementation of this section has been in constant flux, as is evidenced both by the lengthy series of court battles over the TELRIC costing methodology and by the upcoming Triennial Review that the FCC is about to issue. Indeed, the Triennial Review will directly affect the ultimate implementation of this section.

Further, all Section 271 applications are not yet resolved. It should be noted that under Section 271(d)(6), Enforcement of Conditions, it states:

> "if at any time after the approval of an application under paragraph (3), the Commission determines that a Bell operating company has ceased to meet any of the conditions require for such approval, the Commission may after, after notice and opportunity for hearing- …issue an order to such company to correct the deficiencies; …impose a penalty on such company pursuant to title V; …or suspend or revoke such approval."

It is therefore obvious that the 1996 Act prohibits the FCC from using the means of a forbearance petition to deal with the subject matter of the definition of, or the costs for, UNEs. However, it is precisely such forbidden turf that Verizon's petition asks the FCC to tread on.

III. Practical Problems

It should be noted that Section 401(e) of the 1996 Act states that "a state commission may not continue to apply or enforce any provision of this Act that the commission has determined to forbear from applying under subsection (a)." Therefore, Verizon's petition raises a number of serious practical problems for the states as well as the FCC. These include the following.

First, if the FCC were to reject TELRIC (the result sought by the forbearance petition), what cost methodology would replace it? Verizon wants the FCC to adopt market-based rates, but it is totally unclear what such rates would be based on, because there is no definable market for UNEs. Rather, UNEs, by their very nature, are creations of a regulatory framework. As such, they can only be priced pursuant to a regulatory decision-making process. For this reason alone, Verizon's forbearance petition should be rejected.

Second, it has taken six years to finalize a reasonable methodology for quantifying the value of UNEs. If the FCC grants Verizon's forbearance petition now, it will by necessity trigger an equally long and arduous period of evaluation, negotiation and litigation, for the FCC, for the states, and for the market participants. It is doubtful that this process, should it be entered into, will result in anything better than TELRIC. One thing is sure, however; namely, that this process, if entered into, will bring chaos and confusion to the nascent competitive telecommunications markets. Moreover, because of such resulting uncertainty, it will make it extremely difficult for the emerging competitors to Verizon, as well as for Verizon itself, to raise the money necessary to build out and improve their networks. Such an outcome is surely not what the FCC, or Congress, desires.

Third, it would be difficult to change cost methodologies without new cost studies, and it is likely to take another six years of valuable time before a new costing methodology would be finally accepted by both the courts and the policymakers. During this time, the enterprise of developing competition in telecommunications markets would be in suspension. The likely scenario would be that new generic proceedings would have to be opened in all of the states to deal with the setting of new rates for UNEs. In the past, this process over 4 years in California.

Finally, what happens to all completed proceedings where the prices of UNEs were determined based on TELRIC? Do they get "grandfathered" until a new proceeding opens to address the issue? Do all prior concluded proceedings in all of the states that have conducted them get re-opened? What happens to all current proceedings where TELRIC is the pricing methodology? In the meantime, what happens to cases that come up during this process? Are they left on hold or can TELRIC be used? These questions as well as others need to be addressed before the FCC can go forward with changing the cost methodology for UNEs.

IV. VERIZON'S PETITION FAILS TO MEET THE TEST SET FORTH IN SECTION 401 OF THE ACT.

The standard for the grant of a forbearance petition is set forth in Section 401 of the 1996 Act, which states that are the FCC must determine, based on a record, that (1) enforcement of such regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or telecommunications service are just and reasonable and are not unjustly or unreasonably discriminatory; (2) enforcement of such regulation or provision is not necessary for the protection of consumers; and (3) forbearance for applying such provision or regulation is consistent with the public interest. Section 401(b) goes on to state that the competitive effects of FCC action on a forbearance petition must be weighed. Specifically the statute states:

> "in making the determination under § 401(a)(3), the Commission shall consider whether forbearance from enforcing the provisions or regulations will promote competitive market conditions, including the extent to which such forbearance will enhance competition among providers of telecommunication services. If the Commission determines that such forbearance will promote competition among providers of telecommunications services, that determination may be the basis for a Commission finding the forbearance is in the public interest."

The FCC's own statistics regarding competition indicate, on their face, that any change in the pricing methodology currently being used for UNEs would have the effect of interrupting the competitive market that is slowly gaining strength. Even Verizon's own arguments regarding how UNE-P is hurting their business in effect indicate that competition finally has the possibility of working. It accordingly appears that the real basis for Verizon's petition is to protect it from the effects of the real competition in local telephone service that has been gradually developing under Congressional and FCC tutelage, and is only now beginning to bear fruit.

Thus, through its forbearance petition, Verizon is in effect seeking to undermine the thrust of seven years of federal law, policy and regulatory effort, which have only just recently experienced some effective implementation and have finally brought some stability to the telecommunications marketplace.

V. CONCLUSION

For all of the foregoing reasons, Verizon's Petition for Forbearance should be denied.

By: /s/ GRETCHEN DUMAS
GRETCHEN DUMAS

California Public Utilities
Commission
505 Van Ness Avenue
San Francisco, CA 94102
Phone: (415) 703-1210
Fax: (415) 703-4432

Attorneys for the
Public Utilities Commission of the
State Of California